

INTRODUCTION

The Commission's 2003–2004 reporting cycle was marked by a number of highly significant events that have underscored the expansive and complex nature of the U.S.-China bilateral relationship. These developments demonstrate the vital need for the U.S. government to devote the necessary resources to, and configure effective policies for, managing its relations with the People's Republic of China (PRC). While much of the nation's—and much of the world's—international focus has been on Iraq, Afghanistan, and the U.S. war on terrorism, the United States' relationship with China continues to evolve into our most significant bilateral relationship, one that poses both near-term and long-term economic and security challenges. Accordingly, U.S. policymakers must pay enhanced attention to the many facets of this important relationship.

Among the key developments affecting U.S.-China relations over the past year have been the following:

- Continuing growth of U.S.-China trade, which reached \$181 billion in goods trade in 2003, making China the United States' third largest trading partner, and continued growth of the U.S. goods trade deficit with China to \$124 billion, the United States' largest current and historic bilateral trade deficit.
- Continuing shifts in U.S. manufacturing to China and extensive domestic job losses in the U.S. manufacturing sector.
- The ongoing transition of power in China to a new generation led by President Hu Jintao and Premier Wen Jiabao.
- The escalating nuclear crisis on the Korean peninsula and China's role as intermediary.
- Heightening tensions in cross-Strait relations, marked by China's continued missile buildup and military modernization programs aimed at Taiwan, Taiwan's decision to hold a national referendum on the Chinese missile threat, and the reelection of Taiwan President Chen Shui-bian.
- Beijing's decision to undercut Hong Kong's autonomy and self-governance by unilaterally ruling out near-term direct elections for Hong Kong's chief executive and Legislative Council and prohibiting legislative debate in Hong Kong on this matter.

During the course of this reporting cycle, the Commission undertook a comprehensive analysis of the U.S.-China relationship in the nine areas specified in our Congressional mandate, examining them in the context of these and other emerging developments. The Commission held eleven public hearings, including field hearings in Columbia, South Carolina, and San Diego, California. Through these hearings, the Commission heard the perspectives of members of Congress, current and former senior U.S. government officials, representatives of industry and labor, academics and researchers, journalists, and individuals from trade-impacted communities. All

told, the Commission took testimony from more than one hundred thirty witnesses, the full record of which has been published in hearing-by-hearing volumes forwarded to the Congressional leadership and available on our Web site (www.uscc.gov). A complete list of the hearings and witnesses can be found in appendix IV.

The field hearings and the publication of individual hearing volumes were new initiatives by the Commission this reporting cycle. The field hearings in South Carolina and San Diego allowed the Commission to hear “on-the-ground” perspectives in two regions of the country particularly affected by U.S.-China economic relations. The publication and distribution of our hearing records on a hearing-by-hearing basis, accompanied by a cover letter from the Commission setting out initial findings and, if appropriate, recommendations to Congress on the topic of the hearing, allowed more timely dissemination of the information elicited at our hearings to the Congress and to the interested public.

The Commission’s fact-finding and examination process also included supporting several significant research projects by outside experts. The Commission funded statistical analyses of China’s role in world trade and investment and China’s impact on the U.S. manufacturing base, and comprehensive reports on China’s acquisitions of foreign weapons and military technologies, as well as on China’s compliance record with its World Trade Organization (WTO) commitments. Moreover, the Commission continued its work in translating articles from influential publications within China discussing Beijing’s economic and security strategies and its perceptions of the United States. All of these items are available to the public on our Web site.¹

To further support its research and investigations, the Commission undertook two fact-finding missions abroad. A delegation of the Commission traveled to the headquarters of the WTO offices in Geneva, Switzerland, during December 7–9, 2003, to interview WTO officials, officials of the U.S. Mission to the WTO, and representatives of key WTO member country delegations about China’s first two years of membership in the organization. A second Commission delegation traveled to Tokyo, Hong Kong, and Taipei during March 14–23, 2004, to meet with senior government officials, American and local business organizations, and experts from academia and the media on the economic and security implications for the region of China’s growing economic and political prowess. During the trip to Asia, the Commission delegation also observed the Taiwan presidential election on March 20, 2004.

STRUCTURE OF THE REPORT

The Report presents its key findings, analysis, and recommendations to Congress in nine chapters, organized in three sections capturing the major themes of our Congressional mandate. While our analysis has been divided in this manner, all of these areas interrelate in assessing the broader question of how the U.S.-China economic relationship affects U.S. economic and national security interests. We recognize that the United States’ vast trade and investment relationship with China can never be divorced from the larger geopolitical and military developments at issue.

Section I: U.S.-China Trade and Economic Transfers

- **Chapter 1—China’s Industrial, Investment, and Exchange Rate Policies**
- **Chapter 2—China in the World Trade Organization: Compliance, Monitoring, and Enforcement**
- **Chapter 3—China’s Presence in the Global Capital Markets**

The first section of the Report focuses on the economic dimension of the U.S.-China relationship. Bilateral trade and investment flows between the two countries are taking place on a massive and rapidly increasing scale. Assessing how these flows are affecting the U.S. economy—and with that U.S. economic security—is an essential area of the Commission’s work. In this section, the Commission examines three significant components of U.S.-China trade and investment: (1) China’s industrial, investment, and exchange rate policies and their impact in particular on the U.S. manufacturing base; (2) China’s record of compliance to date with its WTO commitments; and (3) U.S. financial flows to China via the global capital markets.

Section II: Regional and Geostrategic Developments

- **Chapter 4—China’s Regional Economic and Security Impacts and the Challenges of Hong Kong and Taiwan**
- **Chapter 5—China’s Proliferation Practices and the Challenge of North Korea**
- **Chapter 6—China Energy Needs and Strategies**

This section groups chapters addressing China’s rise as a regional power and its central role in the global security challenges stemming from the proliferation of weapons of mass destruction (WMD) and access to energy supplies. Together, the chapters weigh the extent to which China is contributing to or undermining a more stable global security environment. China’s enhanced diplomatic efforts with its regional neighbors contrasts with its hard-line actions relating to democratic developments in Hong Kong and Taiwan. Its intermediary role in the North Korea nuclear crisis will be a major test of U.S.-China relations. Each of these developments poses serious challenges to existing U.S. interests and policies.

Section III: Technology and Military Advancements

- **Chapter 7—China’s High-Technology Development and U.S.-China Science and Technology Cooperation**
- **Chapter 8—China’s Military Modernization and the Cross-Strait Balance**
- **Chapter 9—Media and Information Control in China**

This final section of the Report assesses China’s rapid advancements in technology development, military modernization, and media control. These advancements are altering bilateral and regional trade flows, the cross-Strait military balance, and the Chinese government’s ability to control the media and shape perceptions of the United States and its policies.

FUTURE WORK

As the Commission moves into its third reporting cycle, it will continue its investigation into the areas outlined above and its year-to-year assessment of how the landscape is changing from the standpoint of U.S. economic and national security interests. Within this broad mandate, there are a number of areas that the Commission believes deserve particular attention over the coming year via Commission hearings and research. These areas include, but are not limited to, the following:

Impact on the U.S. Economy—The regional, state, and sectoral dislocations in the U.S. economy resulting from the bilateral trade and investment relationship and measures to help mitigate the impact of these dislocations on affected U.S. workers and communities.

Global Factor Mobility—The implications of increased mobility of capital, labor, and technology for the conduct and governance of international trade and economic activity.

Tax Incentives—How U.S. tax policies impact U.S. investment flows to China, particularly manufacturing and research and development (R&D).

Capital Markets—The role that state-invested enterprises (SIEs) play in the Chinese economy and as part of its capital markets strategies.

Cross-Strait Policies—The underlying premises of U.S. cross-Strait policies; how they have been altered by continuing changes on both sides of the Strait; and the policy adjustments the United States should make in response.

Cooperation on Anti-Terrorism Initiatives—The nature and extent of U.S.-China cooperation and coordination on anti-terrorism matters.

U.S.-China Energy Relations—How U.S. energy policies toward China impact other areas of concern in U.S.-China economic relations—such as manufacturing competitiveness—and how to find the appropriate balance.

China's High-Technology Development—The wide-ranging means by which U.S. technology flows to China and the effectiveness of U.S. government efforts to coordinate, monitor, evaluate, and address these flows; China's use of technology standards as a barrier to trade and an inducement for technology transfer; the policies and strategies implemented by the Chinese government to attract high-tech investment, including R&D, from the United States and other developed countries; and how these issues affect the competitiveness of the U.S. technology industry.

Media Control—Further review of the Chinese government's use of media controls to shape perceptions of the United States, in particular the effectiveness of e-mail, Internet access, and cell phone text messaging as forms of information flow in China; and the ability of the Chinese government to control these new media.

ENDNOTE

1. The research papers prepared by outside experts under contract to the Commission are intended to support the Commission's ongoing research efforts and are posted to the Commission's Web site in unedited form. The Commission's posting of these materials does not imply an endorsement by the Commission or any individual Commissioner of the views expressed therein.

SECTION I

U.S.-CHINA TRADE AND ECONOMIC TRANSFERS

The first three chapters of the Report focus on the economic dimension of the U.S.-China relationship. Bilateral trade and investment flows between the two countries are taking place on a massive and rapidly increasing scale. Assessing how these flows are impacting the U.S. economy—and with that U.S. economic security—is an essential area of the Commission's work. In this section, the Commission examines three significant components of U.S.-China trade and investment: China's industrial, investment, and exchange rate policies and their impact in particular on the U.S. manufacturing base, China's record of compliance to date with its World Trade Organization (WTO) commitments, and U.S. financial flows to China via the global capital markets.

Chapter 1 details the ways in which China's industrial, investment, and exchange rate policies are impacting the nature and scope of U.S.-China trade. The chapter focuses on the growing U.S. trade deficit with China, China's undervalued exchange rate, China's mercantilist trade and industrial policies, and the impact of these policies in particular on the U.S. manufacturing sector.

The dominant feature of U.S.-China economic relations is the U.S. goods trade deficit with China, which rose by more than twenty percent in 2003 to a record \$124 billion. Over the past ten years, the U.S. deficit with China has grown at an average rate of 18.5 percent, and if it continues growing at this rate, it will double in approximately four years. The U.S. deficit with China now constitutes over twenty-three percent of the total U.S. goods trade deficit, and China is by far the largest country component of the overall U.S. deficit. Moreover, U.S. goods trade with China—with \$28 billion in exports to China as compared with \$152 billion in imports—is by far the United States' most lopsided major manufacturing trade relationship as measured by the ratio of imports to exports. China is heavily dependent on the U.S. market, with exports to the United States constituting thirty-five percent of total Chinese exports in 2003, while only four percent of U.S. exports go to China. The trade deficit with China is of major concern because (i) it has contributed to the erosion of manufacturing jobs and jobless recovery in the United States, (ii) manufacturing is critical for the nation's economic and national security, and (iii) the deficit has adversely impacted other sectors of the U.S. economy as well.

A key factor contributing to the deficit is the undervaluation of the Chinese yuan against the U.S. dollar, which gives Chinese manufacturers a competitive advantage over U.S. manufacturers. Economic fundamentals suggest that the Chinese yuan is undervalued, with a growing consensus of economists estimating the level of undervaluation to be anywhere from fifteen to forty per-